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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 634

THEODORE A. MEYERS and wife, ALICE V. MEYERS,
Petitioners

v.

THE UNITED STATES, *Respondent*

REPLY BRIEF FOR PETITIONERS

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JURISDICTION

The judgment of the Court of Claims was entered October 2, 1956 (R. 33a).[1] Jurisdiction of this Court is invoked under 28 U.S.C., Section 1255 (1). In the Petition, the section was inadvertently referred to as 1254 (1).

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[1] Record references are to petitioners' brief.

QUESTIONS PRESENTED

I. Whether the Court below, by its decision, sanctioned the taking of property in an arbitrary manner by upholding a patently defective net worth computation employed by the Commissioner of Internal Revenue in determining petitioners' income tax liability for the calendar year 1948.

II. Whether the increasing of petitioners' net worth for the calendar year 1948 by adding thereto a non-business bad debt in the amount of $43,159.99, sustained in such year upon investments made in prior years and for which no deduction was claimed by petitioners, constitutes such an arbitrary determination and collection of taxes that, if permitted to stand, the judgment of the Court below would do violence to the concept of fairness and equality upon which our system of jurisprudence is founded.

III. Whether the Court below, by refusing to permit petitioners "to explain the discrepancies in the case," referred to by the Court below in its opinion, constitutes a substantial denial of due process of law.

STATUTES INVOLVED

The applicable provisions of the Internal Revenue Code (1939) appear at pages 3-5 of the Petition.

STATEMENT

In summarizing the facts, as found by the Court of Claims, respondent neglected to mention that the 90-day letter referred to on page 3 of its brief, and also found as one of the facts by the Court below (R. 8a), reflected an over-reporting of income by the petitioners for two successive years following that for

which a deficiency had been determined. Respondent presumably sought to avoid this fact on the alleged grounds that only the calendar year 1948 is now in controversy. The fact is, however, that the deficiency for 1948, as actually determined, could not exist without creating overpayments of taxes for the calendar years 1949 and 1950. These two years, therefore, are an integral part of this case.

Relative to the non-business bad debt in the amount of $43,159.99 (which sum was actually added to petitioners' income for the year 1948), respondent failed to mention that this sum was found by the Court below to represent a decrease in the net book value of the corporate assets of Quonset Inn, Inc., as of February 1, 1948, at which time petitioners took over all of the corporate assets and assumed its liabilities. Briefly, the Court of Claims found that the debt owed by Quonset Inn, Inc., to petitioners exceeded the net book value of its assets by $43,159.99 (R. 10a).

Footnote 5, page 5, of respondent's brief contains a statement at variance with the record. Contrary to respondent's claim, Petitioners did offer evidence as to the amount of cash on hand as of December 31, 1942 as well as the amount on hand as of December 31, 1947. This evidence was in the form of oral testimony of petitioner, T. A. Meyers, who testified at both hearings.

On pages 5, 6 and 7 of its brief, respondent has substantially repeated the findings of the Court of Claims as they related to the question of the item of cash on hand as of December 31, 1942 and December 31, 1947. The evidence introduced by respondent, in whose possession it had always been since early 1949 (re-

spondent refused to produce it at the first hearing), reflected cash on hand in the amount of $50,000 as of December 31, 1942 and $40,000 as of December 31, 1947. At the second hearing, respondent contradicted a portion of this evidence to the extent that it adopted the figure of $50,000 contained in such evidence and rejected the figure of $40,000 which was also reflected therein as representing cash on hand as of December 31, 1947. The Court of Claims found as a fact that the $50,000 was supported by the evidence and, even though the sum of $40,000 is part and parcel of this same evidence, the Court below found that the sum of $40,000 was not supported by the evidence. In finding that the $40,000, as cash on hand as of December 31, 1947, was not supported by the evidence, the Court below predicated such finding upon assumptions which, in turn, constitute the basis upon which that Court concluded that the net worth method was not arbitrary and capricious (R. 25a and 28a).

ARGUMENT

Respondent contends that this case presents only factual issues not warranting review by this Court. This contention, of course, is not necessarily an accurate one. Furthermore, when, as in this case, the record unequivocally demonstrates that the decision of the Court below is based on so-called facts which have been erroneously drawn from the record, then the record itself should be determinative of such a question. Respondent also argues that the Court below was clearly correct in sustaining the Commissioner of Internal Revenue's use of the net worth method in computing the taxpayers' income. In support of this argument, respondent cites the following cases: *Smith*

v. *United States,* 348 U. S. 147; *Friedberg* v. *United States,* 348 U. S. 142; *Holland* v. *United States,* 348 U. S. 121; *Doll* v. *Glenn,* 231 F. 2d 186 (C. A. 6th); *Lipsitz* v. *Commissioner,* 220 F. 2d 871 (C. A. 4th), certiorari denied, 350 U. S. 845; *Bryan* v. *Commissioner,* 209 F. 2d 822 (C. A. 5th), certiorari denied, 348 U. S. 912; *Glenn* v. *Kentucky Color & Chemical Co.,* 186 F. 2d 975 (C. A. 6th).

The cases thus relied upon fail to bear any factual resemblance to the one under consideration. In the instant case, the petitioners' Federal income tax returns for the years 1943 to 1947, inclusive, had been accepted by the Commissioner of Internal Revenue as correctly reporting their income for those years; there was no progressive increase in petitioners' net worth in excess of the net taxable income reported by them. Moreover, in the instant case, respondent is obliged to concede that petitioners over-reported their income in the two years immediately following the calendar year 1948. It was necessary to create this over-reporting in order for the Commissioner of Internal Revenue to determine a deficiency for the calendar year 1948. None of the cases cited by respondent contains such facts. It is contended on the part of respondent that the examination of the taxpayers' prior tax history in arriving at an opening net worth is sustained by the authorities. The cases cited in support thereof are as follows: *Friedberg* v. *United States, supra; Holland* v. *United States, supra; Kampmeyer* v. *United States,* 227 F. 2d 313 (C. A. 8th), certiorari denied, 351 U. S. 904; *Vloutis* v. *United States,* 219 F. 2d 782 (C. A. 5th); *Leeby* v. *United States,* 192 F. 2d 331 (C.A. 8th). The Commissioner's computation is not supported by tax-

payers' own evidence, including his net worth statement, for the reason that the Commissioner has actually rejected the taxpayers' net worth and superimposed certain adjustments thereon which in and of themselves unquestionably reveal the arbitrary and capricious character of the Commissioner's net worth. The cases relied upon by respondent in this regard are clearly distinguishable from the one in issue. *United States* v. *Calderon*, 348 U. S. 160; *Smith* v. *United States, supra; Warring* v. *United States*, 222 F. 2d 906 (C. A. 4th), certiorari denied, 350 U. S. 861.

The opening net worth for the calendar year 1948 should be the closing net worth for the calendar year 1947. This closing net worth (R. 20a, para. 3) reflected cash on hand in the amount of $40,000; this sum, however, was rejected notwithstanding the fact that it had been previously accepted by the Commissioner of Internal Revenue in accepting petitioners' income tax returns for the years 1943 to 1947, inclusive.

Petitioners are well aware of the principle that the determination of the Commissioner of Internal Revenue is presumptively correct and that they have the burden of proving that it is wrong. The following cases were cited by respondent in support of this principle: *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357; *Reinecke* v. *Spalding*, 280 U. S. 227; *Koscove* v. *Commissioner*, 225 F. 2d 85 (C. A. 10th); *Staudt* v. *Commissioner*, 216 F. 2d 610 (C. A. 4th); *Carmack* v. *Commissioner*, 183 F. 2d 1 (C. A. 5th), certiorari denied, 340 U. S. 875. Again, as is also true of the many other cases cited by respondent, the facts in the cases cited are so dissimilar from those in the present proceeding that the principles enunciated therein can have no application to this case. As a

matter of fact, the Supreme Court of the United States, in the case of *Helvering* v. *Taylor,* 293 U. S. 507, clearly stated that such determination will not be supported when it is shown to be without rational foundation. The decision of the Court below, therefore, is in direct conflict with the decision of this Court in that case.

For the purpose of demonstrating that the Commissioner's determination has no rational foundation it is necessary only to employ the principles of elementary arithmetic. First of all, the Court of Claims (R. 11a, para. 17) found that the net worth statement required $19,211.39 as cash on hand as of December 31, 1947 to make the net income coincide with the $71,579.04 which was reported as taxable income by the petitioners for the year 1947. The Court further stated that, "to give the taxpayers all possible benefits of cash, or the source of cash, it was reduced to zero as of December 31, 1948." If this statement is regarded as sound, how, it is asked, could the Court below also find, by sustaining the Commissioner of Internal Revenue in the overassessments for 1949 and 1950, that the petitioners had $40,367.60 as cash on hand as of December 31, 1949 and the sum of $41,640.51 as cash on hand as of December 31, 1950, and, at the same time, hold that petitioners overreported their income in 1949 by $1000, and in 1950 by $11,832.12? In other words, it is arithmetically impossible for petitioners to increase their cash from zero at the end of 1948 to the sum of $40,367.60 at the end of 1949, a period of 12 months, on a net taxable income, according to the Court below, of $26,768.49, and yet be regarded as having overreported their income on a net worth basis. This same condition pre-

vails, only more so, in the following year, where, it was found that petitioners' net taxable income in 1950 was actually a loss of $8,236.24 and that they again over-reported their income in that year. Secondly, a significant "fact" found by the Court below (R. 16a, paragraph 3) where, among other things, it is stated, "If on the other hand, they had more than $50,000 cash on hand on December 31, 1942, their income would have been less than that reflected by the net worth statement for the ensuing five years." If this is reduced to an absurdum, it might well be argued that, if the petitioners had $1,000,000 as cash on hand as of December 31, 1942, then, as the result of over-reporting their income, they are actually entitled to a refund for five consecutive years. The answer, however, is very simple, that is, if the petitioners actually had $1,000,000 as of December 31, 1942 then that asset is merely carried forward as a constant figure, and would be reflected in the net worth statement as of December 31, 1947. Not only is the determination of the Commissioner lacking in rational foundation, it goes beyond this; it does violence to principles of simple arithmetic. Thirdly, the inclusion of the non-business bad debt in the amount of $43,159.99 as income taxable to the petitioners in the year 1948 is another patent defect showing the determination to be without rational foundation. As to this feature of the net worth, respondent complains that petitioners did not present this contention to the Court below. The record is eminently clear that from the inception of this case, petitioners have contended that the net worth, as actually constructed, was arbitrary and capricious and that it lacked any support from the standpoint of basic arithmetic. Furthermore, the

stipulation of facts, paragraph 8 (R. 33a) establishes that the loan advanced by petitioners to Quonset Inn, Inc. was advanced to it prior to 1948 and that the sum of $43,159.99 represents an accounting loss because the net book value of that which petitioners received in 1948 was less, by that amount, than that which had been advanced in years prior to 1948. This fact was before the Court below. Petitioners are not now advancing any fact which was not before that Court.

Considering now the contention of respondent that the inclusion of the non-business bad debt in the computation of taxpayers' taxable income was entirely proper, we find that the reasoning upon which this statement is predicated deserves more than a cursory examination. Specifically, the respondent states, "If this item had not been included, taxable income would have been decreased by the amount of the non-deductible loss. Thus, if the amount of this loss were not included, taxpayer would, in effect, be allowed to deduct the non-deductible item. A decrease in assets caused by a non-deductible loss, like an expenditure, must be added to net worth to determine the true taxable income for the period." Ostensibly, such reasoning is specious and should be exposed for what it is. Respondent claims, "a decrease in assets, caused by a non-deductible loss, like an expenditure, must be added to net worth. . . . " First of all, an expenditure represents a physical outlay of money and, as such, must have had its origin in income, or, as in a net worth case, is presumed to have such origin and, therefore, such expenditure must be added to any increase in net worth in determining taxable income. When a loss is sustained in the same year in which the assets were acquired, the asset is presumed to have been acquired

from income received in that year, and, therefore, must be added to the net worth in order to preclude such taxable income from escaping taxation. Such is not the case here, however, these loans, representing loan receivables, had been advanced by petitioners prior to 1948 and, therefore, could not have had their origin in income for the calendar year 1948. When petitioners took over the assets of Quonset Inn, Inc. in 1948, the book value of such assets was $43,159.99 less than that which had been previously advanced. To add this economic loss to petitioners' income in 1948, as was actually done and sanctioned by the Court below, is not only arbitrary and capricious, it is tantamount to taking property by wrongful means under the guise of a net worth method. It should be mentioned that there is serious doubt with respect to the propriety of the employment of the net worth method in the instant case. The petitioners will not belabor this point and are willing to accept the responsibility of demonstrating the unreasonableness of the net worth method as constructed. Petitioners have diligently and patiently sought to point out the errors of this net worth, but the Court below, by virtue of inconsistent assumptions upon which certain facts were then found, has refused to recognize them.

As to whether petitioners have been denied due process, it should be observed that petitioners, for the first time, were informed that they had facts "peculiarly within their knowledge to explain the discrepancies involved in the case," when the Court of Claims issued its decision under date of July 12, 1956. Then, as now, the petitioners were at a loss to know precisely what the Court below meant by that statement. In an effort to ascertain this, petitioners'

counsel sought to give his testimony in the belief that the discrepancies referred to might possibly relate to the item of cash on hand in the original partial net worth. The discrepancies, it is submitted, are not peculiarly within the knowledge of petitioners, in fact, they stand in bold relief for all to see. They are the handiwork of the Commissioner of Internal Revenue and they have received the sanction and approval of the Court below. Moreover, such discrepancies form the very basis upon which petitioners have consistently contended that the net worth was arbitrary and capricious; that the net worth could be supported only by making erroneous and speculative assumptions which are later stamped with the label of "facts".

CONCLUSION

Based on the foregoing argument, and those contained in the petition, it is most respectfully submitted that a writ of certiorari should be granted in this case.

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